Client Alert.

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President Obama Signs 2010 Tax Relief Act

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Today, President Obama signed the Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010 (the “Act”) into law.

The Act extends the Bush era tax rates for individuals. In addition to extending favorable rates, it also has some important business incentive provisions that our clients should be aware of. Finally, the Act includes temporary modifications to the estate, gift and generation-skipping transfer tax rules. This Client Alert summarizes the key provisions.

EXTENSIONS FOR INDIVIDUALS

Tax Rate Extensions and AMT Relief

The Bush era tax rates with respect to income, capital gains and dividends for individuals were scheduled to expire at the end of 2010. The Act, however, extends these rates for an additional two years. As a result, through 2012:

- the marginal tax rates applicable to an individual’s regular income will be 10%, 15%, 25%, 28%, 33%, and 35%;[1] and
- the capital gains and dividend tax rates for individuals below the 25% bracket will be 0% and for those in the 25% bracket and above will be 15%.[2]

The Act further includes alternative minimum tax (“AMT”) relief for individuals for the taxable years beginning in 2010 and 2011. It increases the AMT exemption amounts for 2010 to $72,450 (married individuals filing jointly), $47,450 (unmarried individuals), and $36,225 (married individuals filing separately), and increases the AMT exemption amounts for 2011 to $74,450 (married individuals filing jointly), $48,450 (unmarried individuals), and $37,225 (married individuals filing separately).[3]

Temporary Employee Payroll Tax Cut

The Act also provides that for calendar year 2011, the employee FICA tax, which applies up to the taxable wage base of $106,800, is reduced to 4.2% from 6.2%. The employer FICA tax remains 6.2%. Consistent with this, the self-employment tax rate (which also applies up to the taxable wage base of $106,800) is reduced for 2011 to 10.4% from 12.4%.[4]

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[1] Upon expiration, the marginal tax rates become 15%, 28%, 31%, 36%, and 39.6%.
[2] Upon expiration, the capital gains rates become 10% and 20%, respectively, and dividends will be subject to tax at ordinary income rates. Further, capital gain rates applicable to certain specified categories, for example collectibles gain, are not affected by the Act and remain unchanged.
[3] Further the Act repeals the personal exemption phase-out and the itemized deduction limitation and extends the marriage penalty relief for the standard deduction and the 15% bracket, all for an additional two years through 2012.
[4] The Medicare hospital insurance tax rates equal to 1.45% (for the employee and for the employer) and 2.9% (for self-employed), respectively, on covered wages remain unchanged.

Other Individual Tax Extensions

For individuals, the Act extends the following provisions through 2011: (i) the above-the-line tax deduction for teachers and other school professionals for certain educator expenses; (ii) the election to take an itemized deduction for state and local general sales taxes in lieu of the itemized deduction for state and local income taxes; (iii) the increased contribution limits and carryforward period for contributions of appreciated real property for conservation purposes; (iv) the above-the-line tax deduction for qualified tuition and education expenses; (v) the provision permitting tax-free charitable distributions from an individual retirement account for individuals that are older than age 70½[5]; (vi) the increased exclusion for employer-provided transit and vanpool benefits; and (vii) the provision allowing certain mortgage insurance premiums to be treated as qualified residence interest.

In addition, the Act extends the estate tax look-through rule for regulated investment company stock[6] so that it applies to estates of decedents dying before January 1, 2012. Finally, the Act adds a new provision to the Internal Revenue Code of 1986, as amended (the "Code"), providing that all refundable tax credits and refunds are disregarded as income for purposes of determining eligibility (and benefit levels) of means-tested programs, effective for amounts received after December 31, 2009 and on or before December 31, 2012.

BUSINESS PROVISIONS

Bonus Depreciation

The Act provides 100% "bonus depreciation" for "qualified property" acquired after September 8, 2010 but before 2012 and 50% "bonus depreciation" for "qualified property" acquired during 2012. Thus, under the Act, businesses would be able to deduct the full cost of their 2011 investments in qualified property and half the cost of their 2012 investments in such property. Qualified property generally includes most equipment and software, but not most real property (*e.g.*, buildings). More specifically, qualified property includes tangible property with a depreciation period of 20 years or less, certain water utility property, certain computer software, and certain leasehold improvement property (generally, certain interior improvements).[7]

100% Exclusion for Gain on Small Business Stock

The Small Business Jobs Act of 2010 ("SBJA") increased the exclusion from taxable income for gains from the sale of qualified small business stock ("QSBS") to 100% for QSBS held for at least five years and provided that none of such gain is subject to the AMT. Under the SBJA, both of these changes applied only to QSBS acquired after the date of enactment of the SBJA (September 27, 2010) and before the end of 2010.

The Act extends the 100% exclusion (for both regular tax and AMT purposes) to QSBS acquired after September 27, 2010 and before January 1, 2012. The five-year holding period requirement continues to apply. Accordingly, taxpayers

[5] The Act also allows individuals to make charitable transfers from their individual retirement accounts during January 2011 and elect to treat them as if made during 2010.

[6] In essence, the estate tax look-through rule for regulated investment company ("RIC") stock provides that RIC stock owned by a non-U.S. person is not deemed property within the U.S. in the proportion that, at the end of the quarter of the RIC's taxable year immediately before a decedent's date of death, the assets held by the RIC are debt obligations, deposits, or other property that would be treated as situated outside the U.S. if held directly by the estate.

[7] See our prior client alert for more details on the specific requirements to qualify for bonus depreciation at http://www.mofo.com/files/Uploads/Images/101213-Job-Creation-Act-Provides-100-Percent-Bonus-Depreciation.pdf.

have one additional year to acquire QSBS the sale of which could qualify for the 100% exclusion.[8]

Other Business Tax Extensions

For businesses, the Act also extends the following key provisions through 2011: (i) the research and development credit; (ii) business tax credit for employers of qualified employees that work and live on or near an Indian reservation; (iii) new markets tax credit; (iv) work opportunity credit; (v) track maintenance credit; (vi) credit for training mine rescue team members; (vii) the provision that provides eligible small business employers with a credit in respect of wage payments to activated military reservists; (viii) special 15-year cost recovery period for certain leasehold, restaurant, and retail improvements; (ix) special seven-year cost recovery period for property used for land improvement and support facilities at motorsports entertainment complexes; (x) provision allowing businesses to claim an enhanced deduction for the contribution of food inventory; (xi) provision allowing C corporations to claim an enhanced deduction for contributions of book inventory to certain public schools; (xii) provision allowing businesses to deduct their contributions of computer inventory to certain schools; (xiii) provision providing businesses with 50% bonus depreciation for certain qualified underground mine safety equipment; (xiv) provision that allows film and television producers to expense the first $15 million of production costs incurred in the U.S. ($20 million for costs incurred in economically depressed U.S. areas); (xv) provision allowing for the expensing of costs associated with cleaning up hazardous sites; (xvi) provision extending the domestic production activities deduction under Section 199 of the Code to activities in Puerto Rico; (xvii) special rules regarding interest, rents, royalties and annuities received by a tax-exempt entity from a controlled entity; (xviii) the rule that includes a RIC within the definition of a “qualified investment entity” under Section 897 of the Code; (xix) the active financing exception from Subpart F of the Code; (xx) look-through treatment of payments between related controlled foreign corporations under the foreign personal holding company rules (see below); (xxi) the provision allowing S corporation shareholders to reduce their basis in their S corporation stock for a charitable contribution by reference to the property’s basis rather than its fair market value; (xxii) the designation of certain economically depressed areas as Empowerment Zones eligible for special tax incentives; (xxiii) the designation of certain economically depressed areas within the District of Columbia as the District of Columbia Enterprise Zone, in which certain business and individual residents are eligible for special tax incentives; and (xxiv) the first-time homebuyer credit for the District of Columbia.

The Act extends a provision allowing a regulated investment company (“RIC”) to designate all or a portion of a dividend as an “interest-related dividend” under certain circumstances. The Act also extends the current treatment of interest-related dividends and short-term capital gain dividends received by a RIC to taxable years of the RIC beginning before January 1, 2012.

The Act also extends the Qualified Zone Academy Bond (“QZAB”) program providing an additional $400 million for 2011.[9]

Energy Incentives

Under Section 1603 of the American Recovery and Reinvestment Act, the Secretary of the Treasury is authorized to provide a cash grant to each person who places in service depreciable property that is part of a qualified renewable electricity production facility. In general, the grant amount is 30% of the basis of the qualified property. The Act extends

[8] For more details, see our client alert titled Temporary 100% Exclusion for Gain From Certain Small Business Stock Extended at http://www.mofo.com/files/Uploads/Images/101217-Small-Business-Stock.pdf.

[9] QZABs are a form of tax credit bond which offer the holder a federal tax credit instead of interest. In general, a qualified zone academy is any public school below college level that is located in an empowerment zone or enterprise community and is designed to cooperate with businesses to enhance the academic curriculum and increase graduation and employment rates.

eligibility for the cash grant to property with respect to which the applicant commences construction in 2011. A number of other energy-related provisions will be extended through 2011, including, but not limited to, the $1.00 per gallon production tax credit for biodiesel and diesel fuel created from biomass and the $0.50 per gallon alternative fuel tax credit (but the credit will not be extended for any liquid fuel derived from a pulp or paper manufacturing process).

Controlled Foreign Corporation Provisions

The Act extends for two years (for taxable years beginning before 2012) the temporary exceptions from subpart F foreign personal holding company income, foreign base company services income, and insurance income for certain income that is derived in the active conduct of a banking, financing, or similar business, or in the conduct of an insurance business for controlled foreign corporations ("CFC"). The Act also extends the "look-thru rule" which provides that dividends, interest, rents, and royalties received by one CFC from a related CFC are not treated as foreign personal holding company income to the extent attributable or properly allocable to income of the payor that is neither subpart F income nor treated as effectively connected with the conduct of a trade or business in the United States.

PROVISIONS NOT EXTENDED

While the Act extends many tax cuts, there are several tax relief provisions that have either expired or are set to expire and that are not being extended under the Act. These include (i) President Obama's Make Work Pay credit; (ii) the exclusion from taxable income of benefits for volunteer firefighters and emergency medical responders; (iii) the additional standard deduction for state and local property taxes; (iv) many infrastructure-related incentives, including the Build America Bonds, exempt-facility bonds for sewage and water supply facilities, and recovery zone bonds; (v) a provision granting tax-exempt eligibility to loans guaranteed by federal home loan banks; (vi) provisions encouraging banks to invest in tax-exempt bonds from small issuers; (vii) several low-income housing benefits; (viii) a credit for alternative motor vehicles; (ix) the credit for electricity produced at open-loop biomass facilities; (x) certain steel industry fuel incentives; and (xi) several tax benefits for timber gains.

TEMPORARY MODIFICATION OF ESTATE, GIFT AND GENERATION-SKIPPING TRANSFER TAX PROVISIONS

Estate Tax Changes

The Act addresses the unusual situation that was created by the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), which repealed the estate tax for 2010 but would have imposed it again in 2011 *at the 2001 rates and exemptions*. Widely disparate estate tax situations resulted, with estates of decedents dying in 2009 being subject to a top estate tax rate of 45% for estates in excess of $3.5 million, estates of decedents dying in 2010 being subject to *no* estate tax (but being subject to a modified carryover basis system), and estates of decedents dying in 2011 slated to be subject to estate tax at a 55% rate for estates in excess of $1 million (with a 60% top rate applying to certain large estates).

The Act reinstates the federal estate tax for 2010 through 2012 but at a lower rate — 35% —than has applied in at least a generation. In addition, the "applicable exclusion amount" (basically each person's estate tax "exemption") is increased to $5 million, the highest it has ever been. This exemption amount will be indexed for inflation. The Act also introduces a new "portability" feature, which allows a surviving spouse to take advantage of the unused exemption of a predeceased spouse.

The Act permits estates of decedents dying in 2010 to choose between the Act's estate tax system and EGTRRA's carryover basis system, depending on which system yields more of a benefit to the estate.

Gift Tax Changes

The Act increases the gift tax exemption amount to $5 million, and sets the gift tax rates for gifts beyond that amount at 35% through 2012. The 35% rate is the same as the 2010 rate, but is lower than the 55% rate that otherwise would have applied in 2011. The Act also "unifies" the gift and estate tax exemptions in 2011 and 2012, meaning that an individual has a total exemption of $5 million that can be used on lifetime *or* testamentary gifts before the gift or estate tax will apply on the excess.

Generation-Skipping Transfer Tax Changes

The generation-skipping transfer ("GST") tax has been a separate transfer tax at a flat 55% rate, imposed on gifts (including distributions from trusts) in excess of an exempt amount to persons two or more generations below the transferor. EGTRRA caused the repeal of this tax in 2010, but it would have been reinstated in 2011 at its 55% rate for GST transfers in excess of $1 million. The Act increases the exemption to $5 million and lowers the GST tax rate to 35% for 2011 and 2012 (the GST tax rate is pegged to the unified estate/gift tax rate). The Act also increases the GST exemption amount to $5 million for 2010, and imposes a GST tax rate of "zero" for 2010. This allows significant generation-skipping planning to occur at the end of this year.

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